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# Comment of Professor Patricia A. McCoy on Docket No. CFPB-2020-0028

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**on Docket No. CFPB-2020-0028**
**RIN 3170-AA98**

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Director Kathy Kraninger
Consumer Financial Protection Bureau
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Kraninger:

Thank you for the opportunity to comment on the CFPB's proposed rule on the definition of a seasoned Qualified Mortgage (QM) loan. I am a law professor at Boston College and previously served as Assistant Director for Mortgage Markets at the CFPB.

## I. Introduction And Summary Of Comment

In August 2020, the CFBP issued a proposal to define a new category of QM loans for first-lien, fixed-rate, covered transactions that have fully amortizing payments and do not have loan features proscribed by the statutory QM requirements, such as balloon payments, interest-only terms, maturities longer than 30 years, or points and fees above prescribed amounts. Under the proposal, lenders would have to consider and verify applicants' income and financial resources in determining ability to repay and keep the loans in portfolio until the end of a three-year seasoning period. The loans would also have to meet specific performance requirements. Covered transactions that satisfied the seasoned QM requirements would receive a safe harbor from liability for violations of the ability-to-repay rule at the end of the seasoning period.

When Congress enacted the QM provision, it did so to incentivize lenders to make "high-quality, low-cost" home mortgages. The seasoned QM proposal would contravene Congress' intent by giving legal immunity to riskier seasoned loans with subprime interest rates and high debt-to-income ratios, to encourage lenders to make those loans. The proposal would further illegally deny borrowers with seasoned QMs of their statutory private right of action and foreclosure defense for violations of the ability-to-repay rule. Meanwhile, the proposed rule lacks the evidentiary support required by statute to alter the QM definition that Congress mandated by statute. For all of these reasons, the seasoned QM rule, if adopted, would be vulnerable to legal challenge and the CFPB should withdraw it.

Immediately before the pandemic hit, the United States was in an economic expansion and mortgage default rates were historically low. In such expansions, a rising tide lifts all boats and obscures the amount of mortgage risk building in the system. Now, just six months later with Covid-19, the country finds itself in a precarious economic position, with millions of people out of work and others suffering wage cuts. Even before the current pandemic, the CFPB's Assessment Report for the QM Rule reported that "house prices [had] increased and consumers hold more mortgage and other debt (including student loan debt), all of which have caused the [debt-to-income] ratio distribution to shift upward."[1] During Covid-19, those debt loads have weighed down the ability of unemployed and underemployed workers to timely pay their debts and other bills, let alone put food on their tables. This is not the time to gamble on the types of risky loans that the seasoned QM would allow.

## II. <u>Congress Created QMs To Incent Lenders To Make "High-Quality, Low-Cost" Loans</u>

In the wake of the 2008 financial crisis, mortgage loans with risky loan terms, underwriting, or product features experienced disastrously high delinquency rates. These included home mortgages offering negative amortization or interest-only payments; low- or no-documentation loans; and loans with prepayment penalties or balloon clauses.[2] Higher-cost (i.e., subprime) mortgages (in the vernacular sense of the term "higher-cost") also experienced high rates of

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1 CFPB, *Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Seasoned QM Loan Definition, Proposed rule with request for public comment*, 85 Fed. Reg. 53,568, 53,572 (Aug. 28, 2020) [hereinafter Proposed Rule]; *see* Consumer Fin. Prot. Bureau, Ability-to-Repay and Qualified Mortgage Rule Assessment Report 194 (2019) [hereinafter CFPB ATR Assessment], https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf [https://perma.cc/TN8B-8YEA].

2 *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-78R, INFORMATION ON RECENT DEFAULT AND FORECLOSURE TRENDS FOR HOME MORTGAGES AND ASSOCIATED ECONOMIC AND MARKET DEVELOPMENTS 25-26, 46 (2007); *see also* MARK ZANDI & CRISTIAN DERITIS, MOODY'S ANALYTICS, THE SKINNY ON SKIN IN THE GAME (2011) (non-amortizing mortgages); Charles D. Anderson et al., *Deconstructing a Mortgage Meltdown: A Methodology for Decomposing Underwriting Quality*, J. MONEY, CREDIT & BANKING 609, 627 (2011) (reduced documentation loans); Ioannis Floros & Joshua T. White, *Qualified Residential Mortgages and Default Risk*, 70 J. BANKING & FIN. 95-96 & tbl.5 (2016) (interest-only loans and balloon loans); Michelle A. Danis & Anthony Pennington-Cross, *The Delinquency of Subprime Mortgages*, 60 J. ECON. & BUS. 67, 78 (2008) (prepayment penalties); Wei Jiang et al., *Liar's Loan? Effects of Loan Origination Channel and Information Falsification on Mortgage Delinquency*, 96 REV. ECON. & STAT. 1, 7 (2014) (reduced documentation loans); Michael LaCour-Little & Jing Yang, *Taking the Lie Out of Liar Loans: The Effect of Reduced Documentation on the Performance and Pricing of Alt-A and Subprime Mortgages*, 35 J. REAL EST. RES. 507, 519–20 & exh.2, 529 (2013) (reduced documentation loans); Christopher Mayer et al., *The Rise in Mortgage Defaults*, 23 J. ECON. PERSP. 27, 37–40, 42–44 (2009) (reduced documentation underwriting); Roberto G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, 18 HOUSING POL'Y DEBATE 311, 311 (2007) (balloon loans and prepayment penalties); Morgan J. Rose, *Origination Channel, Prepayment Penalties and Default*, 40 REAL EST. ECON. 662, 662 (2012) (prepayment penalties); Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures: Distinguishing Impacts by Loan Category*, 60 J. ECON. & BUS. 13, 15 (2008) (prepayment penalties); John Y. Campbell & João F. Cocco, *A Model of Mortgage Default* 59, fig.6 (Nat'l Bureau of Econ. Research, Working Paper No. 17516, 2011), https://www.nber.org/papers/w17516.pdf [https://perma.cc/X8VF-C238] (negative amortization and interest-only loans); Ronel Elul et al., *What "Triggers" Mortgage Default?* 11, tbl.1 (Fed. Reserve Bank of Phila. Research Dep't, Working Paper No. 10-13, 2010) (non-amortizing mortgages), http://finance.wharton.upenn.edu/~souleles/research/papers/PhilaFedwp10-13.pdf [https://perma.cc/X5TD-959B]; Shane M. Sherlund, *The Past, Present, and Future of Subprime Mortgages* 10 & tbl.5 (Divs. of Research and Statistics & Monetary Affairs, Fed. Reserve Bd., Working Paper No. 2008-63, 2008), http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf [https://perma.cc/L2YC-72R3] (non-amortizing mortgages).

delinquency.[3] Mortgages that combined two or more of those risk features posed an even higher risk of delinquency.[4]

Congress specifically enacted the QM provisions of the Dodd-Frank Act to prevent a replay of such high levels of default. In Dodd-Frank, Congress made a conscious decision not to ban certain high-risk mortgage loan terms or product types outright. Instead, Congress enacted a legal incentive to encourage lenders to make safer loans. That incentive took the form of a legal presumption of compliance with the ability-to-repay rule for loans meeting QM requirements. Higher-risk non-QM loans, in contrast, do carry legal exposure for ability-to-repay rule violations. Essentially, Congress' QM provisions give mortgage lenders a choice: make safer loans—as defined by Congress—in exchange for reduced legal exposure, or make higher-risk loans and forego that legal protection.

The joint explanatory statement of the conference committee to Dodd-Frank emphasized that Congress restricted QMs to "high-quality, low-cost" mortgage loans:[5]

> Title XIV enacts the Mortgage Reform and Anti-Predatory Lending Act. It sets minimum standards for mortgages by requiring lenders to establish that consumers have a reasonable ability to repay at the time the mortgage is consummated. It provides that certain *high-quality, low-cost loans (defined as Qualified Mortgages)* are presumed to meet this standard.

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3 *See, e.g.,* Yuliya Demyanyk, Ralph S.J. Koijen & Otto A.C. Van Hemert, Determinants and Consequences of Mortgage Default 16 (working paper Jan. 2011), https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.360.7683&rep=rep1&type=pdf; Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 REV. OF FINAN. STUDIES 1848, 1862 tbl. 3, 1864 (2011).

4 *See* INFORMATION ON RECENT DEFAULT AND FORECLOSURE TRENDS, *supra* note 2, at 47; Kristopher S. Gerardi et al., *Making Sense of the Subprime Crisis*, *in* LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 109, 112 & exh.15.2 (Robert W. Kolb ed., 2010); CLIFFORD V. ROSSI, RESEARCH INST. FOR HOUSING AM., ANATOMY OF RISK MANAGEMENT PRACTICES IN THE MORTGAGE INDUSTRY: LESSONS FOR THE FUTURE 34 (2010) (noting that in an option-pay ARM, "[t]he combination of reduced FICO together with a simultaneous second lien, a higher loan amount and stated income, stated asset documentation presents incremental default risk beyond the individual risk factors"); Shirish Chinchalkar & Roger M. Stein, *Comparing Loan-Level and Pool-Level Mortgage Portfolio Analysis* 20 (Moody's Research Labs, Working Paper No. 2010-11-1, 2010) ("In the mortgage setting, research suggests that the relationship between, e.g., default probability and loan factors is non-linear, and in some cases highly so . . . ."); Shane M. Sherlund, *Mortgage Defaults* 2–3 & fig.2 (Mar. 8, 2010) (unpublished manuscript) (on file with authors) (noting that a report prepared by Amherst Securities for the Securities & Exchange Commission concluded that "[n]egative equity and the layering of risk are the largest components of default across mortgage products").

5 Joint Explanatory Statement of the Committee of Conference 876 (2010) (emphasis added), https://www.llsdc.org/assets/DoddFrankdocs/dodd-frank-act-jt-expl-statement.pdf. The next sentence in the conference report reiterated the conferees' concern with higher-interest loans, equating "higher-cost" loans with "more abusive mortgages":

> The Act also prohibits financial incentives (including payments known as ''yield spread premiums'') that may encourage mortgage originators, including mortgage brokers and loan officers of lending institutions, to steer consumers to higher-cost and more abusive mortgages.

*Id.* at 876-77.

As is apparent from the reference to "high-quality" loans, the purpose of the QM provision was to limit mortgage delinquency rates.

In order to carry out this statutory purpose, Congress expressly defined QMs to exclude many of the most dangerous types of underwriting practices, product features, and terms that had spawned high default rates during the 2008 financial crisis and its aftermath. Congress also restricted certain cost provisions of QM loans. Specifically, Dodd-Frank states that QMs cannot have:[6]

- Negative amortization, interest-only, or balloon payment clauses;[7]
- Terms exceeding 30 years;
- Total points and fees of typically more than 3 percent; and
- Prepayment penalties, except as provided by statute.[8]

In addition, Dodd-Frank requires verification and documentation of the applicant's income and financial resources for all covered mortgages, including QM loans.[9] In the ability-to-repay provision, Dodd-Frank further instructs the Bureau to determine the proper method for income documentation and verification:[10]

> in order to safeguard against fraudulent reporting, any consideration of a consumer's income history in making a determination under this subsection shall include the verification of such income by the use of—
>
> **(A)** Internal Revenue Service transcripts of tax returns; or
>
> **(B)** a method that quickly and effectively verifies income documentation by a third party *subject to rules prescribed by the Bureau*.

In sum, Congress took pains to tailor the QM statute to target—and discourage—most of the worst lending practices used during the housing bubble. Dodd-Frank's text and its legislative history make clear that the privileges of QM status are restricted to "high-quality, low-cost" loans. It is incumbent on the CFPB to respect the Congressional purpose of the QM statutory provision when considering any expansion to QM loans receiving safe harbor status.

## III. The Proposed Seasoned QM Rule Would Contravene Congressional Intent By Providing A Safe Harbor To Dangerous Types Of Mortgage Loans

As the preamble to the proposed seasoned QM rule makes evident, the proposal would give lenders of all types and sizes a safe harbor from legal exposure for loans with features and terms that Congress specifically intended to exclude from QM status. Specifically, the proposal would

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6 15 U.S.C. § 1639c(b)-(c).

7 The only exception is for balloon loans held in portfolio by small rural lenders. 15 U.S.C. § 1639c(b)(2)(E).

8 Fixed-rate QMs (except higher-cost QMs) may charge prepayment penalties, but only during the first three years after origination and only if the creditor also offers the applicant a loan without a penalty. Such penalties may not exceed 2% in the first two years or 1% in the third year of the loan and thereafter cannot be charged. 15 U.S.C. § 1639c(c)(1). Congress otherwise banned prepayment penalties in home mortgage loans. *Id.*

9 15 U.S.C. § 1639c(b)(2)(A)(iii).

10 *Id.* § 1639c(a)(4) (emphasis added).

allow the following types of loans to attain safe harbor status, so long as they met the seasoning and other requirements of seasoned QM loans:[11]

- Higher-cost loans that now only offer a rebuttable presumption of compliance;
- High debt-to-income (DTI) ratio loans;
- Loans for which lenders document and verify applicants' income and financial resources from bank records alone; and
- Seasoned fixed-rate loans carrying prepayment penalties during the first three years, when they are still non-QM loans;[12]

Loans could combine more than one of these dangerous features and still qualify as seasoned QM loans.

Of added concern, the resale restrictions on seasoned QM loans would be substantially weaker than the stringent resale restrictions that Congress imposed on small bank portfolio QM loans.[13] Further compounding risk, hazardous seasoned QMs could be made by depository and non-depository mortgage lenders alike of any size. This is unlike the alternative QM definitions for small creditor[14] and small bank portfolio QM loans,[15] which Congress and the Bureau carefully restricted to small lenders.

The concern about the broad reach of the proposed rule, which sweeps in all non-depository lenders, is especially pronounced with respect to the operating subsidiaries of insured banks and thrifts. Operating subsidiaries could make risky seasoned QMs, free from the reputational constraints of banks, using financing through infusions of cheap insured deposits from their parent banks or thrifts. Banks are free to make those transfers under Section 23A of the Federal Reserve Act.[16] During the housing bubble, similar high-risk mortgage loans by operating

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11 *See, e.g.,* Proposed Rule, 85 Fed. Reg. at 53,577-78, 53,602 (proposing new 12 C.F.R. § 1026.43(e)(1)(i)(B)).

12 Neither the proposed seasoned QM rule nor the preamble discusses whether the restrictions contained in 12 C.F.R. § 1026.43(g) on prepayment penalties in covered transactions would apply to seasoned QMs. While the proposed rule would require lenders to comply with the "general restrictions on product features" of QM loans, *see* Proposed Rule, 85 Fed. Reg. at 53,602, the actual text of the proposed rule is narrower and only requires seasoned QMs to adhere to the product features limitations in 12 C.F.R. § 1026.43(e)(5)(i)(A)-(B), not those in Section 1026.43(g). See Proposed Rule, 85 Fed. Reg. at 53,602 (proposing new 12 C.F.R. § 1026.43(e)(7)(i)(B)). Given that Dodd-Frank requires all fixed-rate QMs to comply with the prepayment penalty restrictions in 15 U.S.C. § 1639c(c), *see* note 8 *supra*, the Bureau should remove any uncertainty and affirm that the product features requirement of any seasoned QM would include the statutory prepayment penalty restrictions.

13 To qualify for small bank portfolio QM status, an eligible institution must originate and hold the mortgage in portfolio indefinitely, with limited opportunities for resale that limit the acquirers who are eligible and normally require the acquirer to hold the loan in portfolio. 15 U.S.C. § 1639c(b)(2)(F)(iii). To retain safe harbor status, an eligible small bank portfolio loan may only be transferred: (1) to someone else by reason of the institution's bankruptcy or failure; (2) to another small depository institution or credit union that holds it in portfolio; (3) through a merger, so long as the acquirer holds it in portfolio; or (4) to a wholly-owned subsidiary of the small institution, so long as the loan is treated as an asset of the small institution for regulatory accounting purposes. *Id.* In contrast, the proposed rule's resale restrictions would allow resale to any purchaser with no conditions following the three-year seasoning period. *See* Proposed Rule, 85 Fed. Reg. at 53,602 (proposing new 12 C.F.R. § 1026.43(e)(7)).

14 12 C.F.R. § 1026.43(e)(5).

15 15 U.S.C. § 1639c(b)(2)(F).

16 12 U.S.C. § 371c(b)(2)(A).

subsidiaries financed with inter-affiliate transfers by their parent owners were commonplace and contributed to the build-up of mortgage risk culminating in the 2008 crisis.[17]

All loans meeting the requirements of the proposed seasoned QM rule would receive a safe harbor from ability-to-repay violation liability and would also be free from the risk retention requirements. These could include higher-cost, high-DTI fixed-rate loans with loose income verification. Similarly, the seasoned QM definition would encompass high-DTI fixed-rate loans that were not higher-cost but that combined lax income verification with prepayment penalties. In the preamble, the Bureau even floated the possibility of including interest-only mortgages in the definition of a seasoned QM.[18] Congress never intended, however, for those and other dangerous loans—particularly not loans with layered risk--to have the considerable benefit of QM safe harbor status.

In particular, the green light to higher-cost seasoned QM loans—with no legal recourse for injured borrowers—flouts the intent of Congress, as manifest from the conference report. The conference report specifically judged "higher-cost" loans as "more abusive" and reserved QM status for "high-quality, low-cost loans."[19] Economists have consistently concluded that mortgages with multiple risk factors substantially boost the risk of default.[20] In view of the statutory text and this legislative history, it is hard to imagine how higher-cost, high-DTI fixed-rate seasoned QM loans with lax verification could comport with Dodd-Frank's text and Congress' intent. While Dodd-Frank gives the Bureau discretion to "revise, add to, or subtract from the criteria that define a qualified mortgage,"[21] there are limits to that discretion. The statute only permits the Bureau to make such changes, *inter alia*, "upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers *in a manner consistent with the purposes of this section* . . ."[22] As this makes clear, any such changes must accord with the QM statute's purpose, which is to reduce mortgage default risk. Contrary to the purpose of the QM statute, however, the seasoned QM proposal would open the door to *substantially higher* default risk. Under no circumstances does the Dodd-Frank Act allow the Bureau thus to adopt a seasoned QM rule that would eviscerate the QM statute by agency fiat.

## IV. The Proposed Seasoned QM Rule Would Undermine The Private Right Of Action and Defense To Foreclosure For Violations Of The Ability-to-Repay Rule

The whole point of the proposed seasoned QM would be to create a safe harbor for home mortgages that meet its requirements. In the process, the rule, if adopted, would strip borrowers with seasoned QMs of their statutory private right of action and foreclosure defense for violations of the ability-to-repay rule.[23]

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17 *See, e.g.,* WookBai Kim, *Challenging the Roots of the Subprime Mortgage Crisis: The OCC's Operating Subsidiaries Regulations and* Watters v. Wachovia Bank, 21 LOYOLA CONSUMER L. REV. 280, 282-84 (2009).

18 Proposed Rule, 85 Fed. Reg. at 53,579. The Bureau lacks that authority, however, because Congress expressly prohibited interest-only loans from the definition of a QM. 15 U.S.C. § 1639c(b)(2)(A).

19 *See* note 5 *supra* and accompanying text.

20 *See* note 4 *supra* and accompanying text.

21 15 U.S.C. § 1639c(b)(3)(B)(i).

22 *Id.* (emphasis added).

23 *See, e.g.,* Proposed Rule, 85 Fed. Reg. at 53,594.

Under the Dodd–Frank Act, aggrieved borrowers may initiate actions for ability-to-repay violations within three years of the violation.[24] In addition, borrowers who are sued for foreclosure or collection of residential mortgage loans may raise ability-to-repay violations as a matter of defense by way of recoupment or set off with no time limit.[25]

From lenders' viewpoint, the main attraction of QM loans is the protection they provide from ability-to-repay exposure. Under current CFPB rules, the nature of that protection—assuming that the various requirements for a QM are satisfied--depends on the loan price. QM loans that are not higher priced offer a conclusive presumption (that is, a safe harbor) against liability for ability-to-repay violations.[26] Certain higher-priced QM loans,[27] in contrast, only offer a rebuttable presumption.[28] Borrowers with those higher-priced QM loans can rebut the presumption by showing that the originator failed to make a reasonable, good-faith determination that the borrower would have had sufficient residual income or assets to meet living expenses after taking into account the household's monthly obligations.[29]

Congress gave borrowers filing suit three years to prove that their home mortgages had been made in disregard of reasonable ability to repay at consummation. While performing borrowers who successfully make three years of monthly mortgage payments may have difficulty proving an ability-to-repay violation, Congress allowed them to try.

The Bureau's 1022(b) analysis erroneously asserts that "the proposal would not curtail the ability of consumers to bring affirmative claims seeking damages for alleged violations of the" ability-to-repay requirement.[30] But that is not the case. Imagine, for instance, a situation where a borrower sues for violation of the ability-to-repay rule within the three-year statute of limitations, but makes enough current mortgage payments while the lawsuit is pending to satisfy the proposed seasoning requirements. Absent a seasoned QM exception, the plaintiff might nevertheless prove a violation of the rule where he or she, at consummation, lacked enough residual income to cover his or her ordinary living expenses or other debt obligations. Most often, this would be where the borrower had a high debt-to-income ratio as a result of taking out the mortgage. But it could also include someone with a lower DTI ratio but scant income.

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24 15 U.S.C. § 1640(e). Under the provisions of the Truth in Lending Act governing ability-to-repay violations, creditors and assignees face potential monetary liability for actual damages, statutory damages of $4,000 per loan (subject to a cap for class actions), special statutory damages equaling all finance charges and fees paid by the consumer for up to three years, refunds of certain finance charges, and attorneys' fees and costs. *Id.* § 1640(a); CFPB ATR Assessment, *supra* note 1, at 36–37. Special statutory damages cannot be awarded if the creditor proves that the failure to comply was immaterial. 15 U.S.C. § 1640(a)(4).

25 15 U.S.C. § 1640(k)(1).

26 *See* 12 C.F.R. § 1026.43(e)(1)(i) (2019); CFPB ATR Assessment, *supra* note 1, at 44.

27 Normally, higher-priced QM loans have an APR that exceeds the APOR for a comparable loan by 1.5 or more percentage points for a first-lien loan or by 3.5 or more percentage points for a subordinate-lien loan. *See* 12 C.F.R. § 1026.43(b)(4). However, for the small-creditor portfolio QM and rural or underserved small-creditor balloon payment QM alternatives, a higher-priced loan is defined as one whose APR exceeds the APOR for a comparable loan by 3.5 percentage points or more. *See id.*

28 *See id.* § 1026.43(e)(1)(ii).

29 *Id.* § 1026.43(e)(1)(ii)(B).

30 Proposed Rule, 85 Fed. Reg. at 53,549.

Borrowers in these straits might forego needed medical care, go hungry, or run up credit card bills in order to make the on-time mortgage payments needed to keep their homes.

The Bureau openly admits that there may be times when a homeowner who made timely mortgage payments for three years might be able to prove an ability-to-repay violation.[31] In fact, the Bureau's proposal contemplates that some seasoned QM borrowers *would* have payment records indicative of financial distress. We can see this from the proposed rule's seasoning approach, which would allow loans to achieve seasoned QM status with two 30+ day delinquencies—plus deficient payments of up to $50 on three occasions, not to mention additional delinquencies of less than 30 days.

Nor is it necessary to speculate. The CFPB's own 1022(b) analysis sheds light on the chance that borrowers who made mortgage payments for three years straight could still raise a valid ability-to-repay violation. Specifically, the 1022(b) analysis reviewed higher-priced loans made from 1998 to 2008 that had sufficient late payments or delinquencies to disqualify them from seasoning, depending on the prescribed length of the seasoning period. According to that analysis, fully 34% of those loans suffered that disqualifying event more than 3 years after origination and 10% of those loans had disqualifying events in year four.[32] Further, of loans originated in 2012 and 2013, 10.6% had a disqualifying event in year 4 and another 10% did in year 5. This suggests that problematic performance is not limited to the first three years following origination.[33] While most of those borrowers would not have had ability-to-repay violations under current guidance,[34] these percentages are large enough that at least a few might have had claims or defenses had Dodd-Frank's ability-to-repay provision been in effect. Yet, any seasoned QM borrowers in the same position would lose the claim granted to them by Congress under the proposed rule.

Even worse, the proposed seasoned QM rule would violate Congress' decision to afford a defense to foreclosure with no time bar to injured borrowers for violations of the ability-to-repay requirement.[35] The lack of any time bar for the foreclosure defense and recoupment irrefutably shows that Congress never meant for borrowers to forfeit that defense or recoupment based on the number of months of consecutive, current repayment.

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31 *Id.* at 53,578 ("there is [no] exact period after which no delinquencies can be attributed to a lack of ability to repay at consummation"), 53,579 ("it is possible that a consumer could continue making on-time payments for some period of time despite lacking the ability to repay, such as by forgoing payments on other obligations").

32 *Id.* at 53,579, 53,596 fig. 2.

33 *Id.* at 53,599 & tbl. 5.

34 Under current CFPB guidance, proof of successful performance for a "significant period of time" is evidence that the lender complied with the ability-to-repay requirements. CFPB guidance also states that lenders generally cannot be held liable due to *ex post* events that negatively affect a borrower's ability to repay. Comment 43(c)(1)(ii); Comment 43(c)(2). Thus, the litigation risk associated with ability-to-repay loans, while real, is quite small by year four, making litigation risk concerns after the third year following origination without a seasoned QM rule substantially overblown.

35 Proposed Rule, 85 Fed. Reg. at 53,594 (stating that for "[s]easoned QM loans that are non-QM loans or rebuttable presumption QM loans at consummation, the proposal would effectively limit [the foreclosure defense] to approximately three years as a general matter"); *see also id.* at 53,599.

This outcome would be especially egregious for seasoned QM borrowers with higher-priced loans. Currently, the CFPB allows homeowners with higher-priced QM loans to rebut the presumption of ability-to-repay compliance on grounds of insufficient residual income. These are precisely the people who most likely would have a valid ability-to-repay claim and defense despite meeting the seasoning requirements. Yet lenders who converted those higher-priced loans into seasoned QMs could deny them the private relief and defense that Congress mandated.

In the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) in 2018, Congress could have adopted a seasoning requirement that cut off the private cause of action and foreclosure defense, but it did not. To the contrary, when Congress enacted the small bank portfolio QM in that statute, it required originators to hold those loans in portfolio indefinitely (and certainly more than three years), with only limited opportunities for resale.[36] Accordingly, the indefinite holding period required by EGRRCPA reinforces the conclusion that Congress did not intend to authorize a seasoning exception to private relief.

In short, the CFPB lacks the legal authority to eliminate the private cause of action and foreclosure defense that Congress mandated in the case of seasoned loans. Unlike judgments as to questions within the Bureau's technical expertise, moreover, any CFPB attempt to cut off a congressionally mandated right of action or statute of limitations would be vulnerable to legal challenge and would not merit judicial deference under *Chevron*.[37]

## V. <u>The Proposed Rule Lacks The Necessary Evidentiary Basis</u>

The proposed seasoned QM rule lacks the necessary evidentiary basis to alter the statutory QM definition. That is one more reason why the rule, if adopted, would not pass judicial muster.

The stated justification for the proposed seasoned QM rule is to "help ensure access to responsible, affordable mortgage credit."[38] Strangely, the preamble does not explain how the proposal would expand mortgage credit to applicants who traditionally have lacked access to the mortgage market, including lower-income borrowers and people of color. On the supply side, the Bureau's 1022(b) analysis accompanying the proposed rule admits, in fact, that "the Bureau cannot reliably predict how many additional loans would be originated under the" proposal.[39] On the demand side, the 1022(b) analysis concedes that the CFPB cannot "estimate the proposal's potential decreases in price," such as to expand credit availability.[40]

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36 *See* note 13 *supra.*

37 *See, e.g.,* AKM LLC v. Secretary of Labor*,* 675 F.3d 752, 767 (D.C. Cir. 2012) (Brown, J., concurring) (stating that agency "interpretations of statutes of limitations . . . are . . . poor candidates for deference" because "statutes of limitations are not the sort of technical provisions requiring or even benefiting from an agency's special expertise.").

38 Proposed Rule, 85 Fed. Reg. at 53,568.

39 *Id.* at 53,598. While the 1022(b) analysis quantifies the number of prior non-QM originations that would have received QM status under a seasoned QM rule, *id.* at 53,593-94, those loans were made anyway and so do not represent any expansion of access to credit. Rather, that analysis simply shifts the number of already existing loans from one liability category to another.

40 *Id.* at 53,599.

Even taking the argument for expanding access at face value, that argument necessarily assumes that lenders will make ability-to-repay mortgages that they would not otherwise make because the lenders fear ability-to-repay liability after year 3. It seems quite unlikely, to say the least, that lenders would be willing to assume ability-to-repay liability during the first three years – when defaults are highest – but be deterred from making the loan because of fear about liability after the seasoning period ends (notwithstanding what guidance already says about the difficulty of proving ability-to-repay claims after significant periods of successful performance).[41]

Instead, the real reason why the Bureau invokes the words to "help ensure access to responsible, affordable mortgage credit" appears to be that under Dodd-Frank, the Bureau cannot "revise, add to, or subtract from the criteria that define a qualified mortgage" unless it finds "such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section . . ."[42]

The CFPB has to satisfy this statutory requirement because its proposal would alter the statutory definition of a QM in at least two crucial ways. It would curtail the private right of action and foreclosure defense and it would allow some non-QM fixed-rate loans (those awaiting seasoning) to newly have prepayment penalties. Accordingly, the only way the Bureau may revise or subtract from the statutory QM criteria—to the extent it even has discretion to do so--is by showing that its seasoned QM proposal comports "with the purposes" of Congress's QM statute.

As previously discussed, Congress's purpose in enacting the QM exception was to increase the number of "high-quality, low-cost" loans.[43] To evaluate the effect on "high-quality" loans, the Bureau must thus estimate the likely default rate from bestowing seasoned QM status on mortgages and further assume, *arguendo*, that seasoning will actually result in more high-quality loans. While the 1022(b) analysis contains a default analysis, it limits that analysis to loans originated in 2012 and 2013.[44] Relying on those two vintage years alone is fatally flawed. The reason is that 2012 and 2013 vintages have experienced the lowest cumulative default rates of any vintages starting from 1999 on through 2013 (and likely longer).[45] Accordingly, the 1022(b) analysis has no meaningful default risk analysis at all.

Adding to the flimsiness of the default risk analysis, the Bureau does not account for the higher default risk of loan features that a seasoned QM definition would newly allow, including looser income documentation, high DTI ratios, and prepayment penalties on loans where none

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41 *See* note 34 *supra.* Perhaps the Bureau believes that there are lenders who would be willing to make ability-to-repay loans and assume the liability indefinitely but lack the liquidity to do so and therefore need to be able to season loans and then sell them. There is no evidence to support that proposition, and the Bureau cites none. Moreover, the premise of the price-based General QM proposal is that the Bureau needs to make QM as broad as it is today under the GSE Patch because otherwise credit would dry up, *i.e.*, because lenders won't make loans without QM protection. That is flatly contrary to the premise that some lenders would be willing to make non-QM loans and assume ability-to-repay indefinitely but for liquidity constraints.

42 15 U.S.C. § 1639c(b)(3)(B)(i).

43 *See* note 5 *supra* and accompanying text.

44 Proposed Rule, 85 Fed. Reg. at 53,596.

45 *See* Housing Finance Policy Center, Housing Policy at a Glance: A Monthly Chartbook 38 (Jan. 2018), https://www.urban.org/sites/default/files/publication/95981/housing_finance_at_a_glance_a_monthly_chartbook_january_2018_0.pdf.

previously were allowed. Nor does the default risk analysis account for the higher credit risk posed by higher-priced fixed-rate loans, many of which would newly receive safe harbor status under the proposal. There is similarly no discussion of the added default propensity of layered risk loans. All of these have been proven to substantially increase credit risk in mortgage loans. The Bureau's proposal casually assumes that originators who hold loans in portfolio will underwrite them more carefully. But the Bureau provides *no* evidence in support of that assertion, either in the 1022(b) analysis or elsewhere in the preamble.

In sum, because the CFPB conducted no proper default risk analysis for the seasoned QM proposal, the CFPB has not shown that that proposal satisfies "the purposes" of Congress for "high quality" loans. Further, a proposal that would strip important legal protections from higher-priced loans, as the seasoned QM proposal would do, is neither "responsible" nor "affordable," in contravention of Dodd-Frank. As a result, the Bureau lacks authority under Dodd-Frank to modify the statutory requirements necessary to create seasoned QM loans.

## VI. The Proposed Seasoned QM Rule Would Dangerously Loosen Income Documentation And Verification

The documentation and verification requirements in Dodd-Frank form the heart of the ability-to-repay rule. Unless originators use reliable information about applicants' income and other financial resources, they cannot make a "reasonable and good faith determination" of applicants' ability to repay.

The Bureau's proposal in this regard is problematic because it would allow lenders to ignore tax returns and tax transcripts when verifying income, and then give them safe harbor protection despite their poor underwriting judgment. Under that approach, nothing would prevent a lender from originating a prime one-month bank statement loan with direct deposit and still get safe harbor protection.

Specifically, the proposal contemplates allowing lenders to verify income based on bank statements alone, without regard to the applicants' past income tax returns. This is an accommodation to gig economy and other self-employed borrowers. While self-employed applicants typically will not have W-2s or paycheck stubs, they must still report their income to federal and state income tax authorities for tax purposes. If the cash inflows in an applicant's bank account exceed the income reported to the Internal Revenue Service (or if an applicant who probably owed taxes filed no tax returns at all), that casts doubt on two fundamental underwriting considerations: (1) how much of the credits reported on the bank statements reflects income instead of other third party transfers that possibly were meant to deceive the lender; and (2) the applicant's honesty and willingness to repay a mortgage loan.

This aspect of the seasoned QM income verification proposal is ill-advised. The history of the housing bubble tells us that when the mortgage market becomes overheated and there is no meaningful legal exposure, lenders will relax income documentation and verification to vie for market share. That ensued in a spate of liar loans that helped precipitate the 2008 financial crisis.[46]

All told, any decision to allow lenders to turn a blind eye to tax returns that might shed light on an applicant's real income and *bona fides* would go down a slippery slope toward the world with unreliable or inflated income information. We endured that experience in 2008 and we cannot afford to live through that again. Instead, the way to accommodate alternative income documentation is for the CFPB to require confirmation of that documentation using tax returns or IRS tax transcripts.

## VII. **<u>The Safe Harbor For Seasoned QMs Would Negate The Price-Based Approach In The Proposed, New General QM Definition</u>**

In the pending, companion QM rulemaking to revise the definition of a General QM loan, the Bureau proposes to replace the DTI cap in the current definition with a price-based approach. Under that approach, *inter alia*, loans with interest rates that do not exceed a prescribed spread above APOR would receive General QM status. In the proposal, the Bureau argued that risk-based pricing of this type would constrain credit risk while expanding access to mortgage credit.

Unfortunately, if the seasoned QM proposal and the General QM proposal both become final, the seasoned QM rule would create a loophole to the price-based approach the size of a Mack truck. That is because, under the proposed General QM rule, fixed-rate loans exceeding the rate-spread cap would not enjoy a safe harbor. Lenders bent on evading that restriction, however, could issue those loans as seasoned QMs at rates exceeding the rate spread limit for General QMs and get safe harbor status, so long as they held those loans in portfolio for three years. FDIC-insured depository institution lenders and their mortgage lending subsidiaries would find that avenue of evasion especially attractive. Indeed, the seasoned QM is specifically designed to provide QM protections to lenders who otherwise would have to make those loans as General QM loans. The more that lenders took avail of the seasoned QM loophole, the more that would undermine the asserted market discipline from risk-based pricing.[47] The Bureau points to no evidence, furthermore, that holding those loans in portfolio for 3 years would provide that market discipline.

## VIII. **<u>The Exception for Pandemic-Related Temporary Payment Accommodations Could Allow Lenders To Demand Immediate Repayment of Arrears Upon Expiration of the Temporary Period</u>**

The proposed seasoned QM rule would extend the seasoning period in cases where lenders made temporary payment accommodations due to the Covid-19 crisis. Putting aside the other problems with the seasoning proposal, the treatment of temporary payment accommodations is a further flaw. Although the seasoned QM proposal would not apply to loans with contractual balloon terms, the proposal does not make clear whether the consumer protections in Reg. X §

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[46] *See* Jiang et al., *supra* note 2; LaCour-Little & Yang, *supra* note 2.

[47] In my prior comment letter on the proposed General QM definition, I further explained why the market discipline effects of the price-based approach are questionable.

1024.41(c)(2)(v)(A)(1) would apply to all such temporary payment accommodations.[48] To the extent that it does not, the proposed rule would still allow lenders granting temporary payment accommodations to demand full repayment of the resulting arrears at the end of the temporary period. This would be a balloon term in all but name and the CFPB should not allow it.

Thank you for considering my remarks.

Sincerely,

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Former Assistant Director, Mortgage Markets, Consumer Financial Protection Bureau

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[48] Under this new Covid-19 emergency rule, a mortgage servicer who offers a homeowner a "payment deferral" must allow the homeowner to resume regular mortgage payments when a forbearance or delinquency ends and account for the months of missed payments by placing them at the end of the loan term. This prevents the borrower from facing a balloon payment immediately after the forbearance ends. Instead, the borrower would be allowed to pay the deferred amount when the mortgage loan was refinanced, the loan term ended, the mortgaged property was sold, or any mortgage insurance on an FHA-insured loan terminated.